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The year of political crises is proceeding. The important question for us is whether the U.S. can avoid a recession as we move through the summer and into the fall. The U.S. has frequently had a recession when consumer confidence is so low and falling; we have almost never had a recession when banks are liquid and corporate cash is so high and rising. We have forward momentum; it is broad but weak. Falling gasoline prices should help consumer spending in the second half. Housing appears to be bottoming and should add rather than detract from growth from here. Export growth, which has been a source of strength since 2009, is now providing less support for our economy. Further easing by the Fed is possible, and even likely, if the economy deteriorates from here.

Citizens have extremely low confidence in our political process. The rancor of a Presidential election is rising as we advance toward November. The Supreme Court validation of "Obamacare" creates political churning, but at least it reduces one uncertainty for business planning.

The "foreign cliffs," which we described in our May 22 letter, remain. Time has passed, and we have avoided a blow-up in Europe, but progress has been negligible. Specifically, the Greek elections on June 17th returned a coalition government committed to the EU-mandated austerity program. The austerity steps – eliminating layers of redundant civil servants - have not yet been put into effect, so the real test of Greek resolve and EU willingness to lend more still lies ahead.

The June 28 summit meeting of EU heads of state was to outline fiscal integration. This was the 19th summit attempt to fix European problems, so expectations were low. Maturing Spanish and Italian bonds can be refinanced in the private market only at devastatingly high interest rates. They need a European central credit facility to buy their bonds. Before the meeting, German Chancellor Angela Merkel had commented that the world would not see such an arrangement, backed by Germany, in her lifetime – meaning no increases in German credit exposure to Southern Europe. (Southern Europe already owes Germany 1.4 trillion Euros or 50+% of German GDP.)

The EU heads of state agreed to draw up rules for the ECB to lend directly to banks in Spain and Italy to help them stabilize their banking systems without putting their countries' credit further at risk. The prospect of having the ECB (read Germany) fix the Spanish banks encouraged the markets. Hence, a huge global market rally on June 29. However, the amounts available are probably insufficient to calm the markets for long, and Germany will probably balk at providing substantially more resources. So the EU saga goes on.

The data from China indicate more slowing. Real estate prices are falling in coastal mega-cities, and real estate investment has been central to China's growth since 2008. China's exports to Europe are falling as Europe slides into recession. But the bustle of business in China continues, especially in China's heartland

and western provinces. Retail spending in China is rising – up 13.8% year over year in May. Most observers predict that China will ease credit more to keep growth in the 7+% range for 2012. That is the most likely outcome, but the risk of a real estate hiccup, pulling China below 7% growth, is rising.

Markets were up for the first six months of 2012. But the market swoon in May, reflecting the weakening economy, took back about half the gains from the first quarter of 2012. For total returns on the world market indices we report to you each quarter, for the second quarter: the S&P 500 lost 2.8%, the Russell 3000® Index was down 3.2%, the MSCI World Index dropped 5.4%, and the MSCI World Index ex the USA lost 7.4%. For the first half of 2012: the S&P 500 rose 9.5%, the Russell 3000® Index was up 9.3%, the MSCI World Index gained 6.0%, and the MSCI World Index ex the USA was up 3.1%.[1]

The positions of our various styles were modified somewhat as the quarter unfolded[2]:

Core Global portfolios, managed by John Conti, are positioned in equities for a slowly growing economy, with recovery led by strength in the housing sector. We recently eliminated the position in Brookfield Asset Management (BAM). Although we still like BAM and believe it is trading at an attractive valuation, we sold the position, nonetheless, as there is an administratively challenging set of circumstances developing in the third quarter. BAM is a very complex company. It is a quasi-merchant bank/private equity firm that invests in long-lived, stable cash flow, infrastructure related businesses. The three primary areas of operation for BAM are alternative energy, industrial infrastructure, and real estate. At present, BAM has all of its infrastructure related assets held in an entity called Brookfield Infrastructure Partners. Its alternative energy assets are owned by a publicly traded partnership called Brookfield Energy Partners. Some of its commercial real estate assets are owned by a publicly traded corporation called Brookfield Office Properties, which we hold in the Core strategy portfolios. The majority of their commercial real estate properties, however, are held directly by parent company BAM. In an effort to simplify their operating structure and make it easier for investors to value the shares, BAM is creating another publicly traded partnership that will own all of its commercial real estate assets. The plan of separation for this entity is currently being reviewed by the regulators. Sometime in the third quarter we expect BAM to issue 10% of the shares in the new partnership to current shareholders by way of a taxable dividend. While this would represent a nice dividend, we think the shares of the real estate partnership could come under immediate heavy selling pressure because they will represent ownership in a Canadian limited partnership. Current owners of BAM are largely institutional and will likely not want to deal with filing tax returns for this new entity. We believe that the best course of action was to sell BAM, and buy the shares back later, if possible, at a price that is low enough to account for the value of the foregone distribution of the partnership units. This is a tricky exercise, but it should save you the administrative hassle associated with owning units in the partnership entity that will soon be distributed to shareholders. Note we do not use publicly traded partnerships in the Core strategy although they are used in several other SeaBridge strategies.

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[1] Results for these indices (S&P 500, Russell 3000®, Morgan Stanley Capital International All Country (MSCI) World Index and MSCI World Index ex USA) are quoted as being somewhat representative of the broader equity markets for comparison to SeaBridge U.S., global, and foreign portfolios. The SeaBridge portfolios differ from these indices (in number of securities held, industry, sector and country weightings, etc). Therefore, in any given period, results for SeaBridge portfolios are likely to differ from the results for these market indices.

[2] Note that some portfolios in a given style may not have participated in some of the trades mentioned below, due to client-specific considerations.

In the Core strategy, we also trimmed our position in Airgas because we thought the share price was approaching fair value. On price weakness, we added to our positions in Whiting Petroleum, WPX Energy, Hubbell, Citigroup, and Plum Creek Timber.

Yield Growth portfolios, managed by Garnett Keith and Howard Chin, are more cautiously positioned with about 55% in equities, 35% in credit instruments or securities backed by energy infrastructure assets or real estate, and the balance in cash and gold miners. During the quarter, we eliminated the gold miners ETF, reduced cyclical and emerging market positions, added positions in H J Heinz, United Technologies, and replaced QBE, an Australian insurance company with J.P. Morgan among financials. The decline in oil prices hit the portfolios hard during the quarter. MLPs fell with the price of natural gas liquids, and our smaller Canadian companies drilling horizontal oil wells fell sharply with the price of oil. We believe these price drops are significantly overdone, but time will tell. We added various fixed income positions and small positions in government guaranteed mortgage REITs and a Singapore industrial REIT. One decision which did not work out well was the sale of Wal-Mart. We sold WMT when the top officers were charged with violations of the Foreign Corrupt Practices Act in connection with bribes paid to get new store sites for their Mexican subsidiary. The stock proceeded to rise to new highs during the quarter as the quintessential "flight to safety" stock. The net result of these changes is what we think is a more conservative portfolio with a somewhat higher yield as we go into the third quarter.

International portfolios, managed by Garnett and Denise Clayton-Purvis, have about 70% in equities. The balance is defensively positioned as a buying reserve. Mostly early and mid-quarter we reduced cyclical positions in Caterpillar, Titan International, Mineral Resources, Praxair, Canadian Natural Resources, and Jasa Marga, the Indonesian toll to road operator. Later in the quarter, we replaced those with less cyclical stocks: Xylem, a global water company, Lawson, a Japanese convenience store operator expanding in China, and Baidu, the "Google of China." Shortly after quarter end, we sold our successful "cash investment" in the Medco/Express Scripts merger, hedged by United Health. We have a lot of cash and buying targets on several stocks if they fall more.

Global Trusts portfolios, managed by Garnett and Bobby Henebry, were shifted significantly during the quarter. The gold miners ETF position was taken out and several emerging market exposures were also dropped. Cyclical exposures in the oil and gas ETF and Johnson Controls (significant exposure to the European auto industry) were removed, as was Chimera, a conventional mortgage REIT. These were replaced with the Vanguard Consumer Staples ETF, and conservative stocks McDonald's and Thermo Fisher in the scientific and medical supplies area. A bond fund and government guaranteed mortgage REITs were added. The net result of these was to reduce cyclicality, reduce exposure to emerging markets, and somewhat increase the yield of the portfolios via larger holdings of bond and preferred shares.

Cautious Core portfolios, run by Garnett, had fewer changes than other styles because they hold larger positions in short term cash investments. As the quarter progressed, the gold miners metals ETF was eliminated as the world outlook became more deflationary. As with Yield Growth portfolios, the Cautious Core portfolios lost money as Baytex and Crescent Point, our Canadian oil drillers, fell with oil prices. Conservative stocks - H J Heinz, Thermo Fisher, and Comcast - were added. At quarter end, we were positioned to buy other conservative stocks, but the rally on June 29th in response to the European summit intervened.

As we said in the May letter, the year ahead has numerous political issues which could spook the markets. Considerable confidence was lost last summer as the world watched our Congress and President work on the debt ceiling. I had always thought Ayn Rand's *Atlas Shrugged* was a far-out polemic. But now I think we are living with a version of *Atlas Shrugged* before our eyes each day. In the absence of clear policy commitments, we think businesses will defer investments and the economy will continue to languish. Eventually, the system should clear and good companies bought at distressed prices should prove to be an excellent investment. However, at the moment, that is an hypothesis which is yet to be proven. Until the outlook is clearer, we emphasize that clients should cover their basic financial needs with conservative positions.

Wishing all a good summer in spite of the challenges,

Garnett Keith

Note: this is a copy of a quarterly commentary sent to clients of SeaBridge Investment Advisors. It is presented in order to illustrate the current thinking of the investment manager. This does not represent an offer to buy or sell securities or interests in any fund.

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